THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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Contagion Watch

> **"A monetary union which later turned out to be particularly conflict-prone, let alone fragile, would not only pose economic problems, it might turn out to be a serious threat to the European integration process."**
>
> **—Bundesbank President Hans Tietmeyer,**
> ***Frankfurter Allgemeine Zeitung*, Dec. 28, 1996**

The collapse of the currencies and financial markets of East Asia have been recognized as severe — but only for Asia. As for the likely impact of these events on the developed economies of North America and Europe, however, it is minimized by finance ministers and government economists. This is typical of the public relations cum economic policy that is being proffered by the policymakers of the G-7. While the percentage of European and American exports that Asia consumes is relatively small, the negative effects of the Asian crisis are mostly likely to be transmitted through the speculative and highly exposed global banking sector.

In this issue we revisit the five major American banks whose speculative activities we touched on in last month's letter. We find further evidence of the havoc the Asian crisis is likely to cause to their balance sheets in particular, and to global derivatives trading and equity investing in general.

We also review the progress of European Monetary Union and find that, much to our dismay, it is likely to proceed on schedule. But monetary union will not solve Europe's biggest problems: chronically high unemployment and anemic long-term productivity growth. Only a commitment by Europe's leaders to reduce the welfare state and allow for greater flexibility in the labor market can do that. But political courage and foresight is in short supply in Europe. Instead, the EU's leading politicians are forcing through the euro as a panacea that can eliminate the need for hard choices. And all this is being done, of course, with very little genuine debate — and with scant consideration of how to address Europe's underlying structural problems.

1998's SHAKY START

As we begin a new year, uncertainty and volatility rule the global financial markets. The financial morass infecting the entire Asian region only deepens. The shock, first viewed as a manageable and even beneficial economic development, at least for the overheated U.S. economy, is developing into a contagious disease spreading throughout the global financial system. How quickly and deeply this potentially most powerful venom attacks is unknown, but it now seems certain to have seriously affected international banks and emerging debt markets. U.S. banks, at the center of the global banking foray into emerging market debt and derivative speculation, appear quite vulnerable.

What's more, this Asian crisis is for the U.S. stock market coming at a bad time because it was already jittery about generally worsening corporate earnings, now reflected in a plethora of profit disappointments. With this troubling development, the U.S. stock market is now hanging at the edge of a cliff.

While the Dow and S&P 500 begin the year unbullishly, with small declines, the much favored financial sector is hit hard. The S&P bank index has lost more than eight percent, led by declines of more than ten percent for JP Morgan, Citicorp and BankAmerica. Hit even harder, the AMEX Security Broker/Dealer index has declined more than 13 percent, with Merrill Lynch losing 15 percent, Paine Webber 17 percent and Donaldson Lufkin & Jenrette down 20 percent.

THIS NEWFOUND SECTOR WEAKNESS IS AN OMINOUS SIGN

Interestingly, the NASDAQ composite is close to unchanged for the year as the technology-heavy NDX index has gains of more than three percent. The Semiconductor SOX index is also up more than three percent, after suffering major losses during the fourth quarter. The vulnerable Russell 2000 shows a decline of almost three percent. In a further example of the unstable environment, gold stocks surged, with the XAU index gaining ten percent in a single day!

Importantly, we ponder the ramifications of recent trading action. Specifically, we suspect that the large hedge fund industry plays a very significant role in the U.S. market. Apparently, they have been aggressive players of the "liquidity trade", with a heavy long bias towards financial stocks, while having been biased short technology stocks. This was a most profitable strategy during the second half of last year but is temporarily a loser. As the decline in their longs is not offset by profits from their short sells, they are forced to adjust positions, only exacerbating their problems.

Additionally, we ponder the significant weakness in the Latin American markets. Already, Mexico, Argentina, Chile, and Venezuela have suffered double-digit losses. While we see the case for Asian contagion, we wonder whether what we are witnessing is selling by leveraged hedge funds and international banks. The latter, certainly, must reduce speculative positions as they are forced to deal with significant Asian loan and derivative losses. (More about this later in the letter.) Or what else could be at work?

In past letters we have written often about the voluminous yen "carry trade" — buying high-yielding bonds around the world on minimal margin with yen borrowed at less than one percent. With ongoing weakness in the yen and spectacular gains in the global securities markets, this trade has been one of history's great money machines. For many U.S. hedge funds, this trade was their life blood. However, for this practice to continue, an essential condition is a strong dollar and a weak yen. Whenever that threatens to change, the big unwinding of these positions will start.

To understand today's environment, one must recognize that the Asian crisis has been a double-edged sword for the yen carry trade. While initially boosting the dollar and propelling a bond rally, it has increasingly impaired the international banks which hold large portfolios of emerging market securities and derivatives. While emerging market debt instruments plunged, the strong dollar/weak yen combination cushioned the yen-carry trade supporting the U.S. bond market. As soon as the dollar substantially weakens, though, as presently through the Clinton crisis, the yen carry trade and the U.S. bond market are in trouble.

Supporting this view is the recent simultaneous sharp sell-off in the U.S. bond and credit markets, as well as very weak currencies and markets in Latin America, and Canada — all supposedly with large yen borrowings financing leveraged security positions. Unfortunately, with Asia in a financial meltdown and general instability in financial markets globally, we see any dollar weakness at this time particularly problematic and destabilizing. Nonetheless, dollar weakness is likely.

"BANKS AS CASINOS" REVISITED

Last month, under the title "When Banks Become Casinos," we took a keen and critical look at five of the large U.S. money center banks: JP Morgan, Citicorp, Chase Manhattan, Bankers Trust and Bank of America. Our analysis focused on the significant risk accepted by these players while aggressively speculating in global financial markets — risk-taking that is greatly underappreciated by investors. In particular, we saw at the time considerable exposure to Asia and massive off-balance sheet derivative positions in foreign exchange, equity, and credit market instruments. After the recent releases of fourth quarter earnings, there is growing evidence that these banks are heading right into serious trouble.

JP MORGAN

To the great surprise and disappointment of investors, JP Morgan reported earnings 35 percent below the fourth quarter of 1996. Total revenues declined seven percent; Finance and Advisory revenues dropped seven percent; Market-making revenues fell 24 percent; Proprietary Investing and Trading revenues were off 11 percent. On the positive side, these poor results were partly offset by Asset Management revenues. Hurting the bottom line, operating expenses surged nine percent.

In a shot seemingly heard around the world, JP Morgan's release included the following: "During the fourth quarter of 1997 JP Morgan designated as nonperforming approximately $587 million in exposure to Asian counterparties. Events in the region have raised concerns regarding certain counterparties in Indonesia, South Korea, and Thailand..."

Last month, we wrote, "Off-balance sheet, JPM has over $3.5 trillion of derivative contracts outstanding, of which $943 billion are options it has written." Well, our only surprise was the market's surprise about this revelation of counterparty problems in Asia. How could this problem be absent, given the vast wealth and liquidity devastation in Asia?

Elsewhere, JP Morgan disclosed: "Market-making in equities produced a loss of $54 million in the fourth quarter, compared with revenues of $83 million a year ago. Losses from managing equity derivative positions during a period of significant market volatility were primarily responsible for the quarter's result." With the S&P 500 still showing a small gain for the quarter, we nervously wonder what the potential magnitude of losses will be if the market ever suffers a serious decline.

BANKAMERICA

"Meeting" Wall Street estimates, BankAmerica (BAC) reported fourth quarter earnings per share (EPS) of $1.12, an impressive 18 percent rise from 1996. These results were much assisted by the "repurchase of 31.7 million shares of common stock and the redemption of Series H, K, L, M and N preferred stock, having reduced stockholders' equity by $3.653 billion." Not so impressive, revenues rose just 3.2 percent for the year and actually declined 2.4 percent from the third quarter. Net interest income for the quarter was down $23 million as net interest margin declined 23 basis points. Trading profits fell $63 million.

In Asia, the bank lost $218 million compared to a profit of $224 million in 1996. BAC's exposure to emerging countries in Asia and Latin America was over $10 billion. In a footnote to its table of foreign exposure, a new sentence is included: "Amounts do not include unrealized gains on off-balance sheet instruments which totaled $10.929 billion for consolidated BAC." In plain language, this represents current derivative-related exposure of which it appears that $3.5 billion is with Asian counterparties. It seems logical to presume that BAC, like JP Morgan, has counterparty problems similar to those admitted by JP Morgan.

Given BAC's troubling, significant exposure to financially impaired Asia and Latin America, the bank's response to the crisis is baffling. First, during the quarter, as the Asian crisis exploded, the company nonetheless used over $550 million to buy back an additional 7.4 million shares of stock at an average price of $74.57. (BAC shares are now trading at $65.50.) Additionally, the bank reduced its provision for credit losses by 15 percent, to $220 million.

CITICORP

Elsewhere, Citicorp reported earnings much in line with estimates. Earnings increased seven percent as revenues grew five percent. However, revenues for its Global Consumer business fell one percent to $3.5 billion.

But owing to rising credit losses, in particular on credit cards, profits were down 20 percent. Trading-related revenue plunged 37 percent, with a trading account loss of $188 million. As the Asian turmoil reduced pre-tax earnings by $250 million, "net asset gains and securities transactions increased $329 million, to $456 million." Venture capital revenue rose $72 million, to $248 million. Even with such blatant one-time and special gains providing acceptable EPS, this is inarguably a very weak performance.

BANKERS TRUST

Beating estimates, Bankers Trust earnings increased 13 percent on the back of corporate finance fees of $324 million, up 20 percent. Trading revenue and related income, however, plummeted 38 percent, to $218 million. Risk management business lost $41 million, attributable to equity derivatives. The Asian operation lost $27 million. While the bulls were quick to laud an apparent shift away from trading to corporate finance, the speculative positions in "Swaps, Options & Other Derivatives" were in reality aggressively expanded by over $4 billion, or 30 percent, during the quarter, to $17.7 billion (over 300 percent of stockholder equity).

CHASE MANHATTAN

At Chase, a 72 percent decline in trading revenues and a loss of $272 million in emerging debt securities was offset by a 12 percent rise in consumer banking revenues and a doubling of corporate finance revenues. Expenses rose 14 percent and net charge-offs in its mammoth credit card portfolio grew to 5.45 percent of receivables from 5.11 percent previously. Remarkably, Chase is claiming to have no significant problems in Asia, even with its $7.4 trillion derivatives portfolio.

For this astonishing fact, Chase's vice chairman for global markets may have indirectly given an astonishing explanation, as reported in a January 16th New York Times article. In regard to his bank's exposure to highly volatile derivative positions in South Korea, he said, "They represent a crisis of confidence that will soon pass and, if contained, do not represent a serious threat to Chase's well being." That's a big "if".

So far, the Asian crisis has been going from very bad to much worse. In the case of Indonesia, there is now a virtual financial collapse where, according to estimates, over 90 percent of publicly traded companies are insolvent and unable to pay interest on their massive debts.

Furthermore, Indonesian banks are no longer honoring foreign exchange contracts. The damage has run much too deep for a recovery in the foreseeable future. If Chase or others have counterparty exposure in Indonesia, they have irrecoverable losses.

THE BLACK HOLE IN THE DERIVATIVES GAME

With the crisis impairing banks and corporations alike throughout the region, the viability of counterparties in derivative contracts is now generally in question. Essentially, the largest derivative exposures of U.S. banks are to Japanese and Korean banks. In Korea, this is in addition to huge loan exposure. The U.S. and other foreign banks are left waiting to see if the Korean government will take over from the domestic banks not only their bad loans but also their off-balance sheet liabilities. It's hard to believe that the Korean government will comply with this

With financial chaos so endemic to the region, managing the existing huge books of derivative positions is becoming extremely challenging, at best. It has always been argued that the market makers and big players in derivatives eliminate risk by diligently "matching their books". In other words, they hedge their positions by offsetting an agreement with one party with an agreement with another. Obviously, this has been invented by academic mathematicians, who are not aware of differences in the underlying solvency of the counterparties.

This problem was sure to explode whenever a major movement in the prices of a currency or an asset would under crisis conditions lead to significant gains and corresponding losses on the supposedly "matched" contracts, as presently in Asia. Here a bank is left with two "matched" positions: a huge receivable on a "winning" position from one party and an equally large liability to another party on a "losing" position. Everything is fine as long as the bank is able to collect on its receivable. Today in Asia, with collapsing economies, currencies and asset markets, defaults on derivative positions are sure to become endemic.

JP Morgan has admitted so much. Others have not admitted to existing problems, and, in fact, claim not to have any. We suspect, they have instead chosen to stick for the time being to the fiction that the counterparties to their "winning" positions are willing and able to pay (perhaps with the help of the IMF). Unfortunately, what makes derivative positions particularly difficult to manage is the fact that the larger the endangered "winning" position the less likely that the other side, the loser, will have the wherewithal to pay. The greatest danger lies in letting such a position run in the hope that the party will pay — only at the end to be stuck with a large, uncollectible "winning" position receivable matched against a large "losing" liability. If that happens on a large scale, there is quickly a systemic problem.

Even if there is no systemic breakdown, we think that these events will usher in significant, and we believe watershed, developments in the derivatives industry. Since the big players now have considerable counterparty issues to work through, we see them for some time being less prone to accept risk. This is critical on two counts:

First, since these major players — international banks and Wall Street firms — have been aggressive buyers of securities globally, we expect a period of retrenchment on their part that is certainly not bullish for financial markets.

Second, these more risk-averse players are less likely to write new derivatives.

Hence, with liquidity disappearing in the derivatives market, financial market participants will be less able to protect against market risk by simply calling their favorite derivative salesman. Instead, to protect against market weakness, investors will have to actually sell securities. We think that this will tend to diminish the speculative froth in the markets.

EURO-QUAGMIRE

We are sorry to say that monetary union in Europe will most probably take place, as planned, at the start of 1999. Nonetheless, we have increasing doubts that EMU will survive the transition period until January 1, 2002, when the new coins and notes are to be introduced.

As repeatedly explained, we are radically opposed to this venture both for political and economic reasons. At the root of our aversion is the conviction that Europe's political leaders have not proved they have the good judgment and stamina to lead such a great and difficult task to anything else than political and economic fiasco. With or without common currency, the situation in Europe calls for great leaders and momentous decisions. But they don't exist.

What these politicians have demonstrated in the face of the massacres in Bosnia and continue to demonstrate in the face of 18 million unemployed in Europe is complete incompetence in statesmanship. Never before in the postwar period have politicians in Europe been held in such contempt as presently. Non-existent leadership, punitive taxes, overextended welfare systems, and excessive subsidies are paralyzing the political as well as the economic system.

EMU — European monetary union — is without doubt the most important economic event in post-war European history. Though EMU is fraught with risks, politicians on the continent implore political vision in order to override any misgivings. While the British government published a paper setting out the advantages and disadvantages of British membership of the single currency, the German public was offered only hollow propaganda.

Typically, the arguments for the common currency are switching to and fro: from claims of great economic benefits to expressions of political idealism, and back again. In this spirit of political opportunism, it is presently claimed that the euro, by stimulating economic activity and competition, will substantially help reduce unemployment.

Ironically, EMU has been primarily conceived and urged forward by the EU foreign ministers. Craving to show major progress towards European integration but being unable to accomplish this in their own fields of competence, such as foreign and security policy, they decided to graze instead in the pasture of the national central banks. They claimed that EMU would act as a pacesetter on the road to political union in Europe. Soon after, Kohl and Mitterand were to seize the idea.

Among economists, as a matter of fact, this idea of the pacesetter role of a single currency has always had very few supporters. In Germany, strikingly, independent academic economists are overwhelmingly opposed, while bank and business economists are just as uniformly in favor.

PACESETTER FOR HARMONY OR CONFLICT?

For sure, the common currency will become an emblem of the new Europe, just as the Deutschemark became the emblem of the new Germany. But the Deutschemark was soon to reflect an economic success story. What will the euro stand for? To exert any uniting influence, a currency has to convey some positive image. If Europe's political leaders will not change drastically, the euro will come to be the pitiful emblem of mass unemployment and economic incompetence in Europe.

A common currency in Europe tainted by persistent, if not growing, mass unemployment will undoubtedly become a source of conflict, rather than unity. But the conflict that we see coming is not between the people but Europe-wide between the people and their politicians.

To emphasize: EMU will have a politically positive effect only if economic conditions in the coming years bring new prosperity and rising employment to Europe. But we don't see the slightest chance for either: a worse moment could not have been chosen for the imposition of a common currency.

For years, the EMU debate has centered on the single question of whether or not the new European Central Bank will prove as strictly committed to the pursuit of price stability and currency strength as the German Bundesbank has been in the past. By now, it should be clear that Europe's scourge of the future will not be inflation, but endlessly rising mass unemployment.

EUROPE'S NEW SCOURGE

The conspicuous thing to see about unemployment in Europe is that over the last two decades it has gone from bad to worse and worse. Until the late 1960s, it had held at an average rate of 2.2 percent. In 1974, it crossed for the first time the threshold of three per cent. Ever since then, the unemployment rate has been rising cycle-by-cycle. In 1980, it nearly hit six percent and in 1990 nearly 8 percent. But in the 1990s, the dismal record turned into outright disaster. For the first time, overall unemployment continued to grow even during a cyclical recovery, and that on the eve of implementing EMU. Specifically, in Germany it is since 1993 in uninterrupted rapid increase.

Consider this: From 1970 to 1997, the U.S. economy generated altogether 51 million new jobs, of which 40 million were in the private sector. That was within 27 years an overall increase of 62 percent, or 2.3 percent per annum. In Europe, the private sector squeezed out only one million new jobs, while the public sector generated eight million.

There is virtual agreement among independent economic experts that the employment malaise has its chief causes in excessive taxes, welfare systems and labor market regulation. But they cry in the wilderness. While the Maastricht treaty is lauded as a strong, joint effort to impose budgetary discipline in Europe, this has in reality never happened. True, budget deficits were reduced but, contrary to elementary economic reasoning, not for the most part by cutting government spending but by tax hikes, fudging, and a series of one-off measures designed to meet the letter, instead of the spirit, of convergence.

Europe's paramount growth-choking structural maladjustment — an excessive government share of GDP — has been completely ignored. Between 1990 and 1997, when governments were supposed to prepare for the common currency, they increased their average tax take from 43.7 percent to 45.5 percent of GDP — compared with 32 percent in the United States. In France, government spending as a share of GDP soared in these years from 50 percent to 54 percent.

A DEPRESSING COMPARISON

EMU proponents like to invoke America's political success as a federal state as their great historic model. Such references only bear out lack of historic knowledge. America's original 13 states had a common language and common culture, and people were still overwhelmingly of British stock and background. All these states had a common institutional and legal tradition rooted in the British parliamentary system.

Since none of these natural advantages holds true in the case of Europe, the responsible European politicians ought to have been even keener on investigating how federal America was actually generated. Compared with the creation and implementation of the American Constitution, the Maastricht Treaty is a bureaucratic monster in incomprehensible language. To highlight the differences, we quote from Paul Johnson's History of the American People:

> "First, the procedure for drawing up the American Constitution was determined by a democratically representative body; Second, the document was written by highly civilized and educated statesmen, in clear (indeed beautiful) language that all citizens could understand; Third, it was extensively examined, debated and approved in whole and in detail by a special Constitutional Convention; Fourth, it was then subjected to national debate at every level from small-town meetings upward; Fifth, it was then ratified by all the member states through special conventions. It was as close to an exercise in democracy as was feasible."

The procedure for European federal union, by contrast, lacks anything that smacks of democracy. In Germany, in particular, it is being imposed on the electorate even though it is well known that the great majority of the population is opposed to it. All relevant documents, far from being written in clear and intelligible language by gifted statesmen, are long, unreadable compendiums of technical jargon put together by lawyers and bureaucrats. And, for sure, even among the so-called political elite, nobody has read them, let alone debated them. Most governments refuse to have a referendum. In short, the move toward federal Europe is taking place in the most undemocratic way. Europe's politicians treat their people with contempt. In turn, that's precisely how the people are looking at them. What unites them is reciprocal mistrust.

YET ECONOMIC CONSIDERATIONS ARE DECISIVE

Decisive for our antagonism to EMU, however, are economic concerns. As earlier explained, EMU's political viability will stand and fall with Europe's economic and employment performance in coming years. If this fails to improve in a meaningful way, the euro and "Europe" will be badly discredited. Looking at best for an irrelevant acceleration in economic growth without any job creation, and at worst for decelerating growth with rising unemployment, growing disenchantment with "Europe" is predetermined.

But why should people turn against "Europe"? In short, because the chief policy competence — for monetary policy — is shifted from the national levels to the European level. Up to the present, unemployment and any other economic failings are rightly blamed on the national authorities. In future, there will remain little room for national policies, so responsibility and blame will fall on "Europe".

More to the point, a common currency robs the member countries of interest rate and exchange rate flexibility as instruments of adjustment at the national level. In future, there will be inflexible exchange rates and one single short-term rate of interest for all. At the same time, narrow budget limits, as foreseen by the so-called stability pact, make fiscal policy impossible.

THE TRULY CRITICAL FACTOR

Europe's crucial economic and social problem is the relentless steep rise in the jobless rate. Responsible for this disaster are partly excessive wage levels, set by the trade unions and business organizations, and partly government measures — primarily onerous taxes and welfare contributions, overly generous social benefits to the unemployed relative to wages, and rigidities in the labor markets.

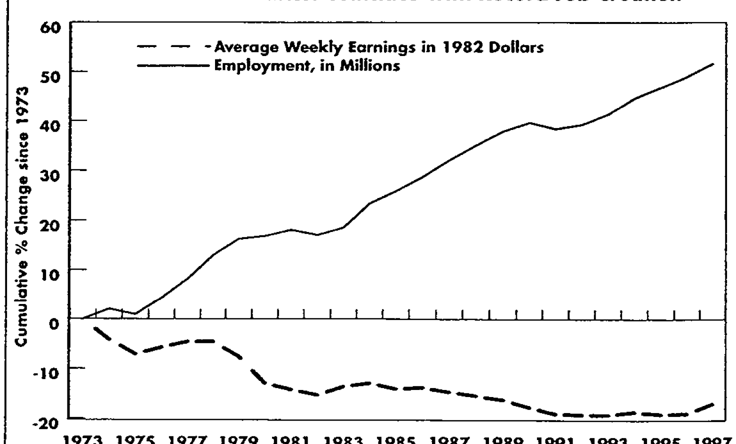
In this light, the Maastricht convergence criteria appear a case of grossly misplaced priorities. Conspicuously, the labor market crisis is a far more significant barrier to European prosperity and harmony than currency fluctuations. A comprehensive policy to address unemployment would impact on the whole economy, while the fixation of exchange rates benefits only the trade-related portion of the manufacturing sector, which accounts for barely 30 percent of GDP and a much smaller part of employment.

The mere fact that high unemployment is absent in many countries and has been successfully reduced in others proves that it can be cured. But in the rest of Europe these cases are conveniently ignored or disparaged as "anti-social". Yet they show that cure is possible if national governments and the wage-setting parties really want to fight unemployment. In Germany, in fact, a lot of flexibility is being introduced on the corporate level. It's the politicians that remain completely inflexible and in outright denial.

WAGES AND EMPLOYMENT — UNITED STATES VERSUS EUROPE

While the failure of governments is blatantly obvious, we shouldn't overlook the crucial role of wage setting. After all, it is the biggest single component in labor costs. Yet there is apparently great confusion about the way wages affect employment. In contrast, "classic" economic theory was absolutely categorical on this point: low wages favor and foster labor-intensive economic growth; high wages favor and foster capital-intensive economic growth. But labor-intensive growth — as presently in the United States — is the same thing as low productivity growth.

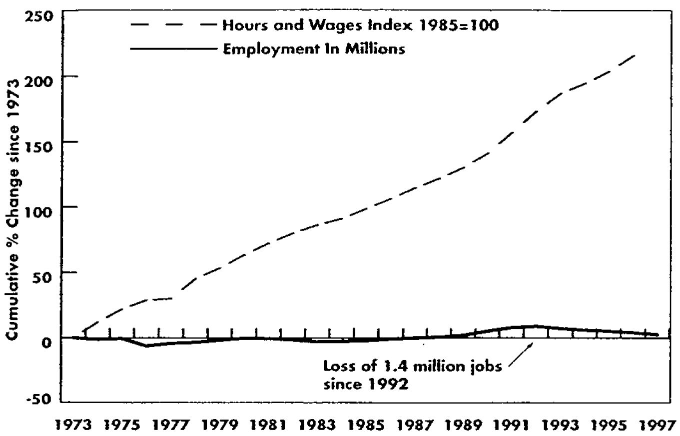
WAGES AND JOBS — UNITED STATES
Flexible Labor Market Coincides with Record Job Creation



Source: *Economic Report of the President*

Since 1973, the famous watershed in world economic growth, U.S. average real weekly earnings have declined by 17 percent. This has coincided with a growth in employment of 47 percent and real GDP growth of 85 percent. That is, more than half of the economic growth

accrued from increasing employment, while the formerly high productivity growth collapsed.



WAGES AND JOBS — GERMANY
Rigid Labor Market Coincides with Stagnant Job Creation

Source: Report of the Government Experts

In most of Europe the growth pattern was the extreme opposite. In West Germany, real hourly wages soared in the same period by 115 percent, while employment grew about four percent. Germany's unemployment disaster started with unification. That's understandable. Not at all understandable is the fact that employment in the West has also fallen by about one million, or 3.5 percent since reunification. Since 1991, the peak of the reunification boom, Germany's GDP has grown by a little over nine percent in real terms. But the snag is that overall productivity rocketed 18 percent, or 3 percent annually, while manufacturing rose 46 percent, or 7.75 percent annually. Thus, Germany ended up with rapidly rising unemployment even during a cyclical recovery. Overall U.S. productivity growth in this period was just eight percent, or 1.3 percent annually.

Historic experience, by the way, manifestly validates the tight relationship between wages and employment. Really dramatic evidence in this respect was delivered during the Great Depression after 1932, as illustrated by the five charts on page ten. At the time, quite a few countries, among them the United States and France, went with sharply rising real wage rates into the depression. In all of them, economic activity and employment failed to recover to the level of 1929. The U.S. economy even collapsed again in 1937. By contrast, Britain, Germany and Japan saw the exercise of wage restraint. Not surprisingly, their economies staged sharp recoveries which permitted employment to rebound past 1929 levels.

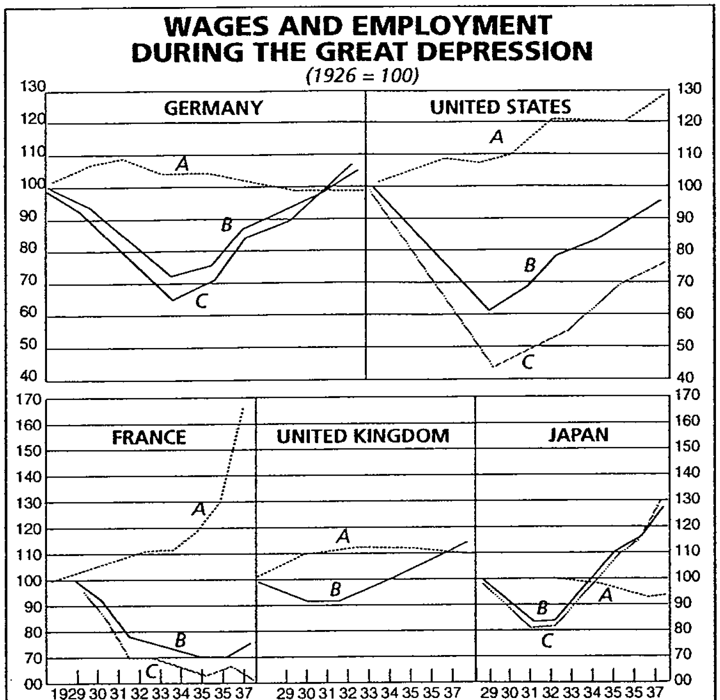
The fact that wages play a dual role in the economy — as cost factor on the one hand, and as source of purchasing power on the other — tends to confound many people. This confusion arises from a failure to distinguish between wage rates and wage income. An excessive rise in wage rates may well translate into falling wage income. That's what has been happening in Europe with a vengeance. (We shall revisit this subject in the next letter.)

With the wage question in mind, we turn next to the situation in the United States. Considering the employment boom, it looks like a great success story, in particular from the perspective of wage policy. In our view, it is a bubble economy that will sooner or later deflate like a punctured tire.

U.S. ECONOMY — INCREDIBLY STRONG?

One of the participants in a recent *Barron's* Roundtable remarked, "The U.S. economy is incredibly strong." If this means strong in terms of demand or GDP growth — no more, no less — we agree for the near term. But we hasten to add that the wording "economic strength" stands in our perception for rather more than just that. What counts above all is the source of such demand growth. Is it "fundamentally" healthy or unhealthy? That's the decisive question.

Being driven by an overborrowing and dissaving consumer and a capital spending boom narrowly based on high tech, the U.S. economy's strength is definitely precarious and ill-founded. It is bubble-strength that tends to deflate like a punctured tire. See Japan; see Southeast Asia.



A Hourly real wages B Number employed* C Aggregated hours worked.**
Source: World Economic Survey 1937-38, League of Nations, Geneva 1938

The happy consensus view has it that the Asian crisis will slow the U.S. economy to a healthier pace, keeping the Fed at bay. This may in fact prove to be the case. Indeed, we see rapid overheating in the real estate and mortgage market with strong potential spillover effects on consumer spending from massive mortgage refinancing fueled by the sharp decline in long-term interest rates. Even though the Fed has not moved, this is tantamount to drastic monetary easing.

Earlier in this letter we pointed to the U.S. economy's incredible employment performance as a main source of the persistently buoyant consumer demand. But while we appreciate the positive correlation between modest wage rises, booming employment and strong consumer spending, this is only part of the growth story. Consumer spending has also been powered in the last years by three further factors: the consumer borrowing binge; substantial dissaving arising from the stock-market wealth effects; and substantial income gains from heavy refinancing in residential mortgages.

Of these three bubble-type stimulants for consumer spending, the first two seem to have reached or passed their zenith. Despite the most solid income gains, credit card delinquencies are well above their previous record high. Yet the biggest threat to the U.S. economy is a bear market in stocks. Financially and psychologically, the U.S. economy's strength has become heavily dependent on a booming Wall Street. As noted before, U.S. economic strength is about bubbles, not about fundamentals.

THE DEATH-KNELL FOR THE BULL MARKET

Clearly, the U.S. stock market is at a critical juncture, despite loose money. Measured by the major indexes, the U.S. stock market has suffered a modest decline from its peak in early August. But these index numbers mask huge losses in numerous individual stocks. The SOX Index is down about 40 percent already; the Morgan Stanley High Tech Index, 21 percent.

At all events, with the average dividend yield around a rock-bottom 1.5 percent, time is working against the bulls. For a long time now, record-high valuations and record-low dividend yields have been dismissed with the argument that persistently high capital gains have made these valuation measures obsolete. But what when the capital gains go awry or — worst of all — turn into protracted losses? We feel sure that if the markets fail to make new highs in the foreseeable future, the bearish forces will become overwhelming. It may not need a specific needle to prick this bubble.

What is the chief actual and potential depressant for the market? In short, the worsening profit outlook versus ridiculously high profit expectations. It was Wall Street's great bull story that the steep rise in corporate earnings during the last four years reflected efficiency gains from cost-cutting and restructuring that would continue in eternity, given the new drive for higher efficiency. The catch phrase was "the shareholder economy."

We have sounded early alarm, first in the August 1996 letter, that this whole story was plain, rank nonsense. As is easy to check, that extraordinary surge in U.S. corporate profits had its true source in various

temporary windfall gains — primarily sharply lower net-interest costs but also declining taxes and slow growth in depreciation.

Corporate earnings held up in 1997 better than we had expected, however, bolstered chiefly by two devices: 1) the burgeoning use of stock options to pay executives and other employees, and 2) huge stock buybacks. With fewer shares outstanding, earnings per share — on which Wall Street focuses — get a boost. Yet it always was clear to u.s. that over time the markets were in for a rude awakening as to corporate profits. In this light, the Asian crisis is an aggravating factor.

We appreciate that the U.S. economy has entered the new year with strong momentum. But we assume that a bear market in stocks — at the very least a disappearance of capital gains — will end it precipitously later in the year. Once real GDP growth trends toward two percent, the markets will start to speculate on rate cuts by the Fed. That may temporarily help the stock market, but it will finally depress the dollar.

GLOBAL ECONOMIC DEMISE

Profit expectations have in the United States been systematically whipped up with Wall Street's euphoric mantra about the great merits of the shareholder value concept. Frankly speaking, all that talk just nauseates us. The truth is that the present economic growth record both in the United States and in Europe compares miserably with that in the longer past. Between 1948-73, the U.S. economy achieved average annual growth of 3.9 percent, of which employment accounted for 1.6 percentage points and productivity growth for 2.3 percentage points. And, besides, nobody was afraid of being suddenly fired, as today.

The big difference from the present was the previous era's much higher productivity growth. Think about it: this was well before Wall Street propagated "shareholder value". The high growth of this era was achieved by strong new investment. Today, Corporate America is cheating the future with merger and acquisition mania and the firing of people. Financial speculation (creating merely pseudo wealth) has replaced productive investment, which alone creates real wealth. In contrast to the rampant euphoria in financial markets, the capitalistic economies are in a relentless demise.

And what is the deeper cause of this demise? In short, increasing capital consumption, defined as a structural process in which consumption — public or private — grabs a rising share of GDP at the expense of investment. In the end, Europe's capital accumulation is no longer sufficient to accommodate present wage levels with full employment, and America's capital accumulation is no longer sufficient to accommodate rising employment with rising wages and living standards. In the long run, this chronic weakness in investment is becoming the primary channel whereby global deflation spreads.

GUESSING ABOUT ASIAN CONTAGION

A new, definitely negative factor for the global economy as well as financial markets is the Asian crisis. But how big a factor? American and European policymakers continue to insist that the Asian financial crisis will have little impact on Europe and America. Their comforting measure is the relatively small export share going to these countries. We find this approach much too narrow.

If there is a threat to the rest of world from the Asian development, as we believe, it is more likely to come through the banking systems rather than through flagging Asian demand for imports. Bank lending to Asia has in recent years ballooned to a total of $385 billion, overwhelmingly to banks and corporations. That's far too much to be taken over by the governments in the region. Completely unknown and not at all taken into consideration are equally sizable counterparty risks from derivative positions, as earlier explained. Undoubtedly, a major hit on the world banking system will cause banks around the world to be more cautious about future

lending. This may well be enough to drag other heavily debt-dependent emerging countries, like Brazil and Russia, into financial trouble.

Some restraint, gradually applied, is only desirable. International lending had become ludicrously excessive in recent years. But experience says that financial markets usually go from one extreme to the opposite extreme. It is important to note that in the 1930s international lending excesses and their subsequent collapse spread the U.S. depression to the rest of the world, even though U.S. interest rates had been slashed to near-zero.

CONCLUSION:

The speed and magnitude of the slump in Southeast Asian fortunes is stunning. No less stunning is the western head-in-the-sand mentality.

This Asian financial and economic crisis has only just started. It will hit the international banks not only through bad loans but also through losses on emerging debt securities and derivative positions. European banks are most exposed in the former, U.S. banks in the latter two.

The most important fallout of the Asian collapse will probably be a general retreat in global lending and financial leveraging, which both had gone to unprecedented excess. The first potential victims are Latin America and Eastern Europe. If the dollar surprises on the downside, as we expect later this year, it will smash the yen carry trade, which has heavily levered global bond markets — predominantly the U.S. credit markets.

The Asian crisis conveniently serves to propound the U.S. shareholder economy as the healthy model for the world. This hubris is just as foolish and dangerous as the prior hubris in Asia because the U.S. economy, too, is a bubble economy. The economy and the financial system are much tied to the Wall Street bubble, which is to burst later in the year.

A key surprise for 1998 may be a sharper-than-expected U.S. economic slowdown. Wall Street will be undermined primarily by proliferating profit disappointments. Once rate cuts by the Fed appear likely, the dollar will sharply decline. Given the huge, chronic U.S. current-account deficit, the dollar will be stuck in a long-term decline, interrupted only by cyclical recoveries.

We have nothing positive to say about Europe. Export-led growth could fall off sharply. But Europe's problems are already largely discounted in the currency markets. The bursting of the U.S. bubble, however, is not.

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